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E.O. 12958: DECL: 02/11/2018

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SUBJECT: AZERBAIJAN ENERGY PLAYERS GIVE STATUS UPDATE ON  
SHAH DENIZ, BTC

Classified By: Ambassador Anne E. Derse per 1.4 (b,d).

¶1. (C) SUMMARY: Key Azerbaijan energy interlocutors agree the key to timely development of the Shah Deniz Stage Two gas project is settling issues of gas transit through Turkey. BP and Statoil claim that the State Oil Company of Azerbaijan (SOCAR) is moving too slowly in signing commercial contracts for selling this gas, but note the importance of an agreement on transit terms for commercial arrangements to be finalized. SOCAR disputes that it is moving too slowly, saying it is in active negotiations, but that absent a solution on Turkish transit it cannot ascertain which pipeline options are most viable. SOCAR claims to have received "mixed signals" on USG support for Nabucco and has asked for a clearer expression of relative USG support for the Nabucco, TGI and Trans-Adriatic Pipeline projects. On oil, SOCAR claims that the ACG Partners turned over control of the Northern and Western pipeline routes to SOCAR in an effort to "manipulate the Production Sharing Agreement" that determines how much profit the Partners make, whereas ACG operator BP says "we just didn't want to run them anymore." On February 13 Statoil Hydro Azerbaijan informed the Embassy that Statoil was going to sign an agreement that day establishing a joint venture with the Swiss EGL group to develop, build and operate the Trans-Adriatic Pipeline.END SUMMARY.

¶2. (C) In recent separate conversations with BP Azerbaijan President Bill Schrader (January 31), Statoil Hydro President Kristian Hausken and Gas VP Jan Heiberg (January 25) and SOCAR VP for Marketing Elshad Nasirov (February 6), in addition to meetings with President Aliyev and SOCAR President Rovnag Abdullayev (February 6-8 - septels) the Embassy sought updates on the status of marketing for Shah Deniz Stage Two (SD2) gas and the related issue of gas transit negotiations with Turkey, plus the issue of BTC pipeline expansion.

Shah Deniz Stage Two

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¶3. (C) BP Azerbaijan President Bill Schrader told the Ambassador one reason the GOAJ was moving relatively slowly on Shah Deniz Stage Two was because SOCAR hadn't done "government to government gas deals" before, which were not like oil deals. He thought Azerbaijan had "no sense of urgency" about moving on Shah Deniz Phase Two (SD2) development, which could begin production as early as late 2013 - early 2014. Schrader said he had told President Aliyev that Azerbaijan first had to sort out gas transit issues with Turkey, after which Azerbaijan could "lock down markets" for SD2 gas. President Aliyev had told Schrader that he wanted to "cut out Statoil" from the marketing of SD2. (Comment: BP says the GOAJ suspects Statoil of "colluding with Botas" against the GOAJ in SD2 development.) Schrader said ideally transit issues should be solved and 60-80 percent of the SD2 reserves committed by the fourth quarter of 2008, when SD2 would be entering the "define" phase, at which point "serious money" starts being spent on development.

¶4. (C) Statoil Hydro Azerbaijan President Kristian Hausken and Gas VP Jan Heiberg also told the Ambassador that for timely development of SD2 (i.e. by the end of 2013), the "key decisions" had to be made by late autumn 2008, with "commercial agreements in place" by the first quarter of 2009. Regarding SD2 marketing, Statoil said that SOCAR didn't have the "secretariat, or the horsepower" to play a leading role.

¶5. (C) Statoil's Hausken and Heiberg also told the Ambassador that the "biggest challenge" facing timely SD2 development was fixing gas transit through Turkey. They said there had been no movement on the issue between the GOT and the GOAJ since August, and that SOCAR had "run out

of ideas." There needed to be a political agreement between the two countries, but they thought President Aliyev was reluctant to engage because he "couldn't swallow another humiliation." Statoil was perplexed as to why Turkey didn't view the Southstream pipeline as a threat.

¶6. (C) Statoil's Heiberg also said that the results from the SDX-04 exploratory well were "different than expected." The Shah Deniz reservoir seemed to be "tilted," which meant that it could have more reserves above the pre-fasila level. The fifth and sixth exploratory wells could confirm these increased reserves. Although current estimates of SD reserves are approximately 28-29 trillion cubic feet (tcf), further exploration could prove reserves of up to 40 trillion cubic feet, or 1.2 trillion bcm ("about one-third of Shtokman"). Heiberg said that regardless, "we have the reserves for a major development and the flexibility to capture the upside." Further good news was that the SD1 wells were going strong, with less than anticipated decline rates.

¶7. (C) Energy Officer asked Statoil about a January 14 Bloomberg story quoting Statoil Executive VP Peter Melbue as saying that Russia's Gazprom would be buying SD2 gas for Southstream. VP Heiberg denied that Statoil was talking to Gazprom about SD2 gas, saying that this executive "didn't know what he was talking about" and was merely trying to "stir up competition" for SD2 gas. Heiberg did say that Gazprom "was not happy" with Statoil for selling GOAJ gas westward, since it wants to use GOAJ as a "gas subcontractor."

¶8. (C) Further putting the lie to rumors of Statoil seeking to sell SD2 gas to Gazprom, on February 13 Statoil Hydro Azerbaijan informed the Embassy that Statoil was going to sign an agreement that day establishing a joint venture with the Swiss EGL group to develop, build and operate the Trans-Adriatic Pipeline (TAP), forwarding a press release to this effect that was going to be released later that day.

¶9. (C) The man responsible for GOAJ oil and gas marketing, SOCAR Marketing VP Elshad Nasirov, bridled at the idea that SOCAR was not moving expeditiously in marketing SD2 gas. After confirming that the GOAJ and SOCAR would have the determinative voice in marketing SD2 gas, Nasirov said that SOCAR was pursuing four main options for SD2 gas:

- TGI (sales to Italy, Greece and Turkey);
- Trans-Adriatic Pipeline (TAP - sales to Italy, Albania, Greece, Turkey);
- Nabucco (Austria, Hungary, Romania, Bulgaria, Turkey);
- Ceyhan-Haifa (Israel - Nasirov considered the GOAJ's participation in this option very sensitive).

¶10. (C) Nasirov said in all likelihood there would only be enough SD2 gas at first to fully support only one pipeline option, and SOCAR and the GOAJ had not decided which project(s) to fully support. The upside for SD2 production was going to be 16 bcm/a. TGI could take 11 bcm/a, which would leave 4-5 bcm/a for Turkey, Georgia and/or Azerbaijan. For its part, OMV wanted at least 4 bcm/a.

¶11. (C) SOCAR was pursuing wide-ranging negotiations, and had signed confidentiality agreements with Nabucco, TGI and TAP, which has allowed the exchange of crucial confidential commercial information. For TGI, SOCAR was pursuing negotiations primarily with Edison; for Nabucco, with OMV and MOL, and soon with Romania and Bulgaria. To dispel the assertion that the GOAJ was foot-dragging in seeking out customers, an upbeat Nasirov said in two weeks during a visit to Hungary there would be a "ministerial joint declaration" between the two countries that would include the need to act jointly to ensure fair gas transit through the relevant countries.

¶12. (C) However, he said supply contracts could only be signed after "all is known," including transit tariffs, which determine the netback to the producer. Whereas SOCAR

could estimate the sales (market) price for its gas in any of these potential consumer countries, without knowing Turkish transit charges, Azerbaijan could not compare the netback value it would get from these four projects. As such, although it was pursuing negotiations for all of these projects, it could not decide which projects to sign on to without having solved transit with Turkey.

¶13. (C) As for charges that SOCAR was slow-pedaling on Nabucco negotiations, he said that "the USG itself hasn't decided which project to support," pointing out that in last year's bilateral USG-GOAJ Energy MOU support for Nabucco was specifically watered down at the USG request. If the USG were now specifically backing the Nabucco pipeline it should let SOCAR know, as SOCAR was deliberating on the relative merits of TGI and Nabucco.

¶14. (C) Continuing on Nabucco, Nasirov said that Turkey was seeking the same 15 percent netback arrangement with the Nabucco pipeline that it was seeking in the TGI project. There was a February 5 Nabucco Executive Board meeting at which the partners would be asked their stance on this stipulation. He said there were indications that if the GOT sought this 15 percent netback option with Nabucco, other Nabucco transit countries might seek the same type of option. Nasirov told Energy Officer that the 15 percent netback proposal was in no way acceptable to SOCAR. SOCAR has "exhausted its tools" in seeking to move the GOT off its position. He saw no use in talking to Botas or Energy Minister Guler, but was now hoping for "active EU lobbying" to convince PM Erdogan to make a political decision.

The Bigger Picture for SD2

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¶15. (C) Nasirov said Azerbaijan was getting "more money

than it could handle" via oil sales, and "it didn't need the money" it would get from selling SD2 gas. Although commercial considerations would play a key role, geostrategic ones would be determinative in deciding where to sell SD2 gas. In selecting which of the four above options it would pursue, Azerbaijan would obviously not choose any that would cause it to lose money, such as the TGI option as long as it included the GOT 15 percent netback stipulation. However, Azerbaijan would focus on strengthening relations with European countries and integrating itself with Europe. This was why SOCAR was not keen on LNG/LPG deals for SD2, since these deals lacked the direct long-term relationship between Azerbaijan as a seller and European consumers.

¶16. (C) When asked specifically about the Whitestream pipeline proposal (a gas pipeline across the Black Sea linking Georgia to Ukraine), Nasirov said that it made financial sense if and only if Turkey insisted on its 15 percent netback clause for GOAJ gas transiting Turkey. For example, if GOAJ transited 30 bcm/a through Turkey (via the Nabucco project), that would mean that the GOT would have the option to buy 4.5 bcm/a from Azerbaijan at a price that would cost Azerbaijan a loss of USD 100 per thousand cubic meters, which equaled losing 450 million dollars of profit annually. At that point, Whitestream would pay for itself in eight to ten years.

¶17. (C) Nasirov said that in dealing with Azerbaijan, Turkey is convinced that there will be no new Black Sea pipeline and that the GOAJ won't sell its gas to Russia or Iran, leaving Turkey the only viable option. Nasirov said that the GOAJ has not specifically mentioned the Whitestream option in public, since it felt that its "Turkish Brother" might be insulted, but that "others" must start publicly pushing the Whitestream option "to get the Turks moving."

¶18. (C) When asked in general about various rumors of SD2 gas sales to Russia, Nasirov was quite explicit and said, "Please tell Washington that Azerbaijan will not sell its SD2 gas to Russia, but might spread such rumors only in order to put pressure on Turkey."

#### BTC Expansion

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¶19. (C) Energy Officer asked Nasirov why at the December 2007 ACG Partners' Meeting SOCAR had opposed introducing drag-reducing agents (DRAs) to the BTC pipeline to expand capacity from 1 million barrels daily (MMbpd) to 1.2 MMbpd. Nasirov explained that SOCAR wants an expanded and powerful BTC pipeline. However, it seeks a "frank and sincere explanation" from the ACG Partners as to why this expansion has to be carried out in 2008, when according to the Partners the 2008 BTC pipeline volume average will be approximately 850 thousand barrels a day (Mpbpd), and volumes from Kazakhstan will not be entering the BTC until 2009 at the earliest. (According to BP's Schrader, BTC volume will reach 1 MMbpd by the end of the third quarter or start of the fourth quarter 2008.)

¶20. (C) Nasirov said he suspected that the Partners' motivation in seeking "early" BTC expansion was "manipulation of the Production Sharing Agreement" (PSA). He said the ACG partners, led by BP, were seeking to influence the Rate of Return (RoR) calculations and thereby put off the date of the next profit split change. (Comment: RoR calculations influence the percentage profit oil split between the ACG Partners and the GOAJ, and have been the main source of ongoing acrimonious negotiations between the two for the last few months. End Comment.)

¶21. (C) Nasirov argued that if the Partners spend the money to boost capacity to 1.2 MMbpd now when the throughput will remain approximately 850 Mpbpd, the transportation costs will increase, thus influencing the RoR in favor of the

partners and pushing off the next increase in the GOAJ of profit oil farther into the future. Nassirov also queried why the GOAJ was being encouraged to buy and then store hundreds of millions of dollars worth of toxic DRAs from the U.S., when Azerbaijan could just as easily produce these agents itself.

¶22. (C) On February 9, BP Azerbaijan Head Schrader told Energy Officer that the ACG Partners were not overly concerned about SOCAR's Objections to BTC expansion to 1.2 bcm/a, as it could (and would) be overridden by a "supermajority" of the ACG partners.

However he said that the Georgian government was threatening to prevent this expansion unless Azerbaijan provided it with more gas at preferential rates (Embassy Tblisi septel).

¶23. (C) BP's Schrader had earlier told the Ambassador that SOCAR and the Partners had agreed to a "non-prejudicial" shift to 50-50 split of profit oil as of January 1, 2008, which became a de facto 55 percent (ACG Partners) 45 percent (SOCAR) split due to Total Transportation Cost (TTC) adjustments. The next major change in profit split would be to 20 percent (ACG Partners) and 80 percent (SOCAR) although the date for this change was still a matter of contention, with SOCAR claiming the date to be April 2008 and the Partners saying April 2009. Schrader predicted the RoR issue would be solved by April 2008, at which point issues about PSA extension and access to ACG Deep Gas could be tackled.

Northern and Western Route  
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¶24. (C) BP's Schrader informed the Ambassador on January 31 of the Partners' transfer of the northern and western pipelines to SOCAR, saying that "BP didn't want to run them." He confirmed that SOCAR wanted volume commitments for these pipelines, which Schrader speculated was probably the reason SOCAR was loath to go ahead with BTC expansion.

¶25. (C) Nassirov confirmed that as of February 1 the ACG partners had turned over to SOCAR ownership and control of the Baku-Novorossiisk pipeline ("Northern Route") and that as of April 1 SOCAR would similarly take ownership and control of the Baku-Supsa pipeline ("Western Route"). He was not happy about these developments, saying he thought the main reason for this transfer was ACG partner BP's concern over "ecological issues," i.e. the fear of an

ecological incident that could further tarnish BP's reputation and drive down its stock price.

¶26. (C) SOCAR was concerned about finding product for these two pipelines, saying that if it couldn't find a minimum of one million tons annually for the Northern pipeline it will shut it down. (Comment: According to press, the Northern Route carried 1.228 million tons of oil in 2007, vice 28.9 tons carried by the BTC.) Additionally, Nasirov found it curious that the 157 Mtpd Western Route pipeline, closed for repairs since October 2006, was being repaired and given to SOCAR just at a time when Georgia has the right to increase tariffs (as of January 1, 2008) and has in fact notified SOCAR that it intends to do so. Nasirov pointed out that these increased Georgian tariffs also influence RoR and oil profit split calculations. Nasirov said the ACG Partners had said that it would "provide some volumes" to help fill these two pipelines, and that SOCAR would be seeking approximately 100-140 Mtpd in this regard.

¶27. (C) COMMENT: We know from President Aliyev and SOCAR President Rovnaq Abdullayev (septels) that the GOAJ is waiting until April 1, when the price of Shah Deniz Phase One volumes to Turkey must be renegotiated and agreed at a market rate, to seek to finalize an agreement on gas transit through Turkey. The GOAJ believes the Turks are seeking to use the 15 percent netback proposal to influence the on-going

negotiations on SD1 gas prices, in part to make up for Botas' "previous mistakes" in negotiating unfavorable gas supply contracts with Iran and Gazprom. The GOAJ is confident that once it reaches agreement on the SD1 price, it can move ahead on the gas transit agreement, possibly with "outside the box solutions" (septel). SOCAR is weighing which pipeline options to pursue for SD2, and the GOAJ is moving as rapidly as we are likely to see on gas supply negotiations until transit is resolved. To encourage the GOAJ to move faster on gas supply negotiations, we need to encourage Turkey to be more forthcoming on transit. The GOAJ seeks a clearer indication of USG preferences, specifically in relation to TGI and Nabucco. If the USG has made a policy decision to push one pipeline over another, we need also to communicate that clearly to the GOAJ.

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